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C O N F I D E N T I A L SECTION 01 OF 03 HONG KONG 000747

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STATE FOR EAP/CM AND EEB/IFD/OMA, TREASURY FOR OASIA

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TAGS: [ECON](#) [EFIN](#) [HK](#) [CH](#)

SUBJECT: HK LEADERS TELL DALLAS FED CHIEF CHINA NEEDS U.S.

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Classified By: Consul General Joe Donovan, Reasons 1.4 b/d

¶1. (C) Summary: Dallas Federal Reserve President Richard Fisher and staff met with Hong Kong government officials, business and finance leaders and the media April 14-15 to explain recent U.S. Federal Reserve actions and to hear local concerns. He reassured interlocutors that the U.S. economy will emerge from the financial crisis stronger and more efficient and promised that the Fed would keep a close watch for inflationary pressures. Business and government leaders told Fisher Hong Kong is beginning to recover already and remains China's only real window into the international financial system. Chinese investors may be interested in Western assets, but will move cautiously in light of their past difficulties. The Chinese leadership is focused on economic development, continues to believe that the U.S. is still the most efficient economy in the world, and understands that China cannot grow absent a U.S. recovery. Boosting domestic consumption in China is crucial for its continued growth, but will take years and face significant bureaucratic obstacles. Chinese leaders were "amazed" at President Obama's election and are willing to "give him a chance." A recent proposal to consider using SDRs as an international reserve currency is more of an intellectual exercise than a policy prescription, but the Chinese are likely to shift their reserve holdings around the edges to better reflect trade obligations and diversify into non-sovereign bonds. End Summary.

¶2. (U) Dallas Federal Reserve President Richard Fisher, accompanied by Senior Economists Mark Wynne and Tao Wu, met with a wide range of senior Hong Kong officials and business leaders, including Hang Lung CEO Ronnie Chan, Mass Transit Railway Corp. (MTR) CEO Raymond Ch'ien, Citibank Asia President Shengman Zhang, Goldman Sachs Managing Director for China Fred Hu, Hong Kong Stock Exchange Chairman Ronald Arculli, members of the Hong Kong/U.S. Business Council, Director General of the Hong Kong Chief Executive's Office Norman Chan, Financial Secretary John Tsang, and Hong Kong Monetary Authority Chief Executive Joseph Yam (reported reftel). Fisher spoke at a well-attended luncheon hosted by the Asia Society and took advantage of Hong Kong's proliferation of international media outlets to give interviews to CNN International, Bloomberg Asia, MSNBC, and the Hong Kong Economic Journal, as well as conduct an impromptu press conference following his Asia Society remarks.

Nurturing Green Shoots, Stopping Deflation
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13. (SBU) In each meeting, Fisher reinforced the message that the U.S. Federal Reserve Board (FRB) has taken extraordinary measures to provide liquidity to the market and with U.S. Treasury has successfully stabilized the financial markets for now. "Green shoots" of recovery are beginning to appear, but much work remains to be done to purge bad assets from bank balance sheets and improve regulatory oversight before the U.S. economy can recover. Although unemployment is likely to exceed 10 percent by 2010, Fisher reassured interlocutors that the U.S. economy will come out of the current crisis stronger and more efficient. He acknowledged concerns about inflation resulting from the FRB's quantitative easing policy, but promised the Fed would watch closely for any inflationary signals and pointed to the potential for deflation as a much greater threat in the current environment. Fisher noted that the U.S. and Chinese economies are closely linked and continued Chinese economic growth is dependent on an American recovery. His public remarks were well received and repeated several times on international news broadcasts.

Chinese Cautious on U.S. Investments

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14. (C) Hong Kong Stock Exchange Chairman Arculli agreed that China needs U.S. markets and expertise to return to its normal rapid pace of economic growth. Chinese companies, both private and state-owned enterprises (SOEs) are trying to attract overseas talent. Arculli, a respected barrister himself, noted that the largest law-firm in China, of which

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he is a partner, is run by Chinese lawyers educated in the West. Many of those returning to China find it difficult to adjust to the bureaucracy and hierarchical management system. That bureaucracy will slow the pace of Chinese investment in the west, according to Arculli. While the China Investment Corp. (CIC) and other SOEs have been cautiously moving to purchase foreign assets, previous losses and resistance from foreign populations are giving them pause, he said.

China Needs Hong Kong, Social Safety Net

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15. (C) Hong Kong's economy is in relatively good shape and still plays an important role for China, despite official support from the Chinese leadership for Shanghai as an international financial center, said Financial Secretary (FS) John Tsang. For now, Hong Kong is China's only real window into the international financial system, he said. Rule of law, accounting standards, and a freely convertible currency give Hong Kong an advantage Shanghai will not be able to overcome for many years. Tsang pointed to the announcement that Hong Kong would be the first jurisdiction to engage in Renminbi (RMB) trade settlement transactions. Hong Kong has already developed a clearing system, he said, and is the logical place to test initiatives designed to gradually increase RMB convertibility. This will encourage additional RMB business in Hong Kong and will complement the other pillars of HongKong's economy: financial services, trade and logistics, tourism, and professional services, said Tang.

16. (C) Citibank Asia President Shengman Zhang agreed that Hong Kong's economy looks to be near the end of its slide. He predicted Hong Kong could see additional bankruptcies, but thought the local economy is starting to turn around. Japan, Korea, Singapore and India are much worse off, while relatively closed economies like Bangladesh and Sri Lanka have escaped the majority of ill effects, said Zhang. China's large reserves and its ability to quickly increase fiscal spending will help it to keep economic growth rates high, but he was skeptical that the fiscal measures would result in a net increase in employment. China needs to create a social safety net and invest in human capital in

order to reorient its economy towards domestic consumption. These goals will take years to meet and the results are not immediately observable, making social spending less attractive to ambitious bureaucrats, he said.

Chinese Leaders: Economics Paramount, U.S. Still Most Efficient

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¶7. (C) Goldman Sachs' Fred Hu recounted a recent meeting with People's Bank of China (PBOC) Governor Zhou Xiaochuan and CIC Chairman Lou Jiwei where Zhou and Lou suggested that political and military issues are secondary to China's economic agenda. The Chinese leadership understands that their economic success is linked closely to a U.S. recovery and they are eager not to do anything to derail the U.S. economy. The rapid collapse of Fannie Mae and Freddie Mac, Lehman Bros., AIG and other American financial institutions took the Chinese leadership by surprise, said Hu, and the U.S. response did not immediately bolster confidence.

¶8. (C) Chinese leaders, however, still trust the strength of U.S. system. Hu recounted a December 18 Central Party Committee meeting where President Hu Jintao reportedly told those assembled, "do not underestimate the U.S. Although the financial crisis is severe, it will not undermine the U.S. system. The U.S. is still the most efficient economy in the world and the U.S. dollar is still the international reserve currency; that will not change any time soon. Although Chinese banks are not heavily exposed to the financial crisis, China is still far behind the U.S. in risk management." Fred Hu pointed to these remarks as evidence that despite some populist rhetoric in the Mainland press, the Chinese leadership are not congratulating themselves, but are rather very clearheaded about the challenges ahead.

SDR Proposal Just Intellectual Debate

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¶9. (C) Dallas Fed Senior Economist Tao Wu asked how President Hu's comments should be taken in light of PBOC Governor Zhou's recent comments advocating use of the IMF Special Drawing Rights (SDRs) as a global reserve currency. Hu speculated that Governor Zhou may have been floating his own idea as a topic for intellectual discussion, or perhaps spoke out of frustration. Zhou made a similar comment at a conference in Malaysia in February that did not provoke much attention. Hu spoke to Zhou both before and after the SDR comment, but on neither occasion did Governor Zhou raise the issue. There is no way to move away from U.S. Treasuries, but the PBOC is likely to rethink its reserve management strategy, said Hu. He predicted the PBOC would give greater consideration to the composition of trade in its reserve allocation, but may be more aggressive in terms of assets, perhaps including purchases of highly rated corporate bonds, including dollar denominated bonds. Although the CIC was burned previously by investments in U.S. assets, when the U.S. economy stabilizes it may begin looking at opportunities in the U.S. market, said Hu.

President Obama Proof U.S. Not Just Talk

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¶10. (C) Hu encouraged Fisher to invite the PBOC to send staff to the Dallas Fed as a means of improving communication between the central banks. He noted that the Strategic Economic Dialogue has been a useful tool for improving understanding and was optimistic that the new Strategic and Economic Dialogue would continue to prove valuable. Chinese leaders were very happy with Secretary Clinton's recent visit and are positive towards the expanded dialogue. Hu

characterized the Chinese leadership as being "amazed" at President Obama's election. Even the most vociferous critics of the U.S. were silenced. President Obama's election is viewed as proof of America's meritocratic system and Chinese leaders are generally "willing to give the President a chance," said Hu.

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